

12.01 Current Liabilities

Overview

Current liabilities are liabilities that will be settled within one year or the operating cycle whichever is longer. Current liabilities are valued at their net realizable value (NRV) or settlement value. They include¹:

- Accounts payable
- Accrued expenses
- Dividends payable
- Income taxes payable
- Current portion of long-term (L/T) debt

Accounts Payable

Accounts payable generally represents amounts due to vendors resulting from the purchase of merchandise.

- Liabilities incurred in obtaining goods and services from vendors in the ordinary course of business
- **Discounts** for prompt payment (eg, 2/10, N/30)
 - **Gross method** – Purchases are shown at gross; if the discount is taken, it is considered a reduction of Cost of Sales.

Purchases	100	
A/P		100

A/P	100	
Cash		90
Discount		10

(COGS ↓)

¹ ASC 210/405

- o **Net method** – Purchases are shown at net, if the discount is not taken, considered interest expense.

Purchases	90	
A/P		90

A/P	90	
Expense	10	
Cash		100

Goods in Transit

FOB shipping point

- Title passes when shipped by seller (placed with carrier).
- Included in buyer's books at year-end as both Inventory and an A/P.

FOB destination

- Title passes when received by buyer (tendered to buyer).
- Included in seller's books until received by buyer. Not included in buyer's books as an A/P until the goods are received.



*FOB = Free on Board

Estimated & Accrued Amounts

Accrued Liabilities/Expenses (Current Liability)

- An expense that is **incurred but not yet paid** in cash (eg, unpaid salaries or taxes at year end).
 - o **Employee's share** of taxes that the employer withholds are not an expense of the employer, even though they are a liability.

Expense (I/S)	X	
Accrued Liability (Salaries payable) (B/S)		X
Accrued Liability	X	
Cash		X

Prepaid Expenses (Current Asset)

- Expenses paid in cash, but not yet incurred (eg, prepaid rent).

Prepaid Expense	X	
Cash		X
Expense (I/S)	X	
Prepaid Expense		X

Deferred Revenues (Current Liability)

- Revenue collected but not yet earned (eg, rent collected or subscriptions collected in advance or gift certificates issued, but not yet redeemed).

Cash	X	
Unearned Revenue (B/S)		X
Unearned Revenue	X	
Revenue (I/S)		X

Revenue Receivable (Current Asset)

- Revenue earned but not yet collected (eg, revenue earned but still due from customer).

Receivable	X	
Revenue (I/S)		X
Cash	X	
Receivable		X

Assume a company paid \$65,000 in expenses. Its beginning balance in accrued expenses was \$7,500 and the ending balance was \$9,000. The beginning balance in prepaid expenses was \$3,800 and the ending balance was \$4,100.

Using a journal entry approach, we know that there was a cash payment, recognized with a credit to cash, of \$65,000. Accrued expenses increased by \$1,500. An increase in a liability is a credit. Prepaid expenses increased by \$300. Prepaid expenses are assets and an increase is a debit. The amount required to balance the entry is \$66,200, representing the amount of expenses incurred.

Expenses (plug)	66,200	
Prepaid expenses (\$4,100 - \$3,800)	300	
Cash (given)		65,000
Accrued expenses (\$9,000 - \$7,500)		1,500

Warranty Costs

Products sold by the client often include warranties promising repairs or replacement for a limited time period. In most cases, it is impossible to determine how much of the sales price is for the product, and how much for the warranty commitment. As a result, revenue is recognized in its entirety on the date of sale, and the estimated warranty cost accrued at the same time.

The method of estimation to be used is the percentage of sales approach. It is similar to the equivalent approach for credit losses (ie, bad debts).

Assume a client has cash sales of \$1,000 in 20X1, its first year of operations. The products are covered by a 2-year warranty, and the client estimates that costs equal to 1% of sales will have to be spent in the first year of the warranty, and 3% of sales in the second and final year of the warranty (repairs are expected to increase as the products get older). Let's also assume the client has spent \$6 on warranty repairs in 20X1.

The entry to record sales is:

Cash	1,000	
Sales		1,000

At the same time, warranty costs estimated to total 4% of sales over the warranty periods are reported:

Warranty expense	40	
Estimated warranty liability		40

The amount spent on actual repairs is applied to the liability:

Estimated warranty liability	6	
Cash		6

Service Contracts

Many retail stores offer service contracts in connection with goods sold. Unlike warranties, service contracts are priced and sold separately, so it is possible to identify the revenue associated with them. As a result, proceeds from the sale of a service contract are systematically allocated over the period of the contract. In this case, actual repair costs are simply recorded as they occur in expenses.

One problem with the allocation of revenue, however, is that a straight-line approach isn't justified, since the amount of repairs and replacements will normally increase as products get older, so more of the revenue is earned later in the contract period.

Assume a 4-year service contract is being sold to customers. Rather than expect that 25% of servicing will take place in each year, it might be more reasonable to expect a steady increase over time, so that 10% of total service is rendered in the first year of the contract, 20% in the second year, 30% in the third year, and 40% in the final year of the contract. Although there will even be a difference between the first 6 months and the last 6 months of each year, let's assume that the pace of repairs within each year is even. If \$100 of contracts are sold in 20X1 throughout the year, the entry for the collection of contract money is:

Cash	100	
Deferred service revenue		100

At the end of the year, revenue for the time that has elapsed on the average contract is:

12/31/X1		
Deferred service revenue	5	
Service revenue		5

Notice that only 5%, not 10%, has been earned by the end of 20X1. This is because the service contracts were sold throughout the year, not all on 1/1/X1, so the average contract is only one-half of a year, not a full year, old at 12/31/X1.

Coupons or Premiums

Many companies issue coupons for discounts on their products, distributing them through newspapers, mailings, and other means. The costs associated with these coupons are uncertain since many of the coupons will never actually be used. For those that are used, the actual cost to the issuer will usually be greater than the face value of the coupon, since merchants redeeming coupons are usually reimbursed for handling costs associated with processing them.

To determine the estimated liability for unredeemed coupons at the balance sheet date, take the following steps:

1. Determine the total face value of the coupons issued.
2. Add the handling fee percentage promised to merchants.
3. Multiply by the percentage of coupons expected to be redeemed.
4. Subtract payments already made to merchants for redeemed coupons.

In determining the estimated liability for unredeemed coupons, ignore any coupons that expired long enough before the balance sheet date so that redemption is no longer considered to have any reasonable chance of occurring.

Assume the client has issued the following coupons, and is attempting to determine the liability for unredeemed coupons at 12/31/X1:

Face value	\$500
Expiration date	12/31/X1
Handling fee paid to merchants	20%
Normal time merchants take to process coupons	One month
Payments to merchants in 20X1	\$300
Total coupons expected to be redeemed	60%

In applying the steps indicated the results are:

- There are \$500 in coupons.
- The handling fee of 20% adds \$100 to the possible cost, making it \$600.

- 60% of coupons are expected to be redeemed, costing \$360.
- \$300 has already been paid out, so that a remaining liability for unredeemed coupons of \$60 exists.

Accrued Vacation Pay

In addition to regular pay, many employees are entitled to future compensated absences such as vacation. Recognition of the cost of these compensated absences must take into consideration two accounting issues (ASC 710):

- **Matching** – Costs should be recognized at the time employees render the services that entitle them to compensated absences.
- **Faithful Representation (Neutrality)** – Costs should only be recognized if they have been paid or are likely to be paid in the future.

Generally, a company will report a liability for future compensated absences if **all four** of the following conditions are met:

- The obligation for compensation for future absences results from services already provided.
- The right to compensation for future absences either vests or accumulates.
- Payment is probable.
- The amount of the payment can be reasonably estimated.

When employees have performed the services, they are typically credited for a specific number of days of compensation, which should be computed at the wage rate expected to be in effect when these days are utilized. If wage rates are adjusted, the liability should also be adjusted.

For vacation days, the recognition of costs is required if the days accumulate or vest.

Accumulation means that days not taken in the current period may be used in a future period.

Vesting means that days not used will be paid in cash at the time of the employee's termination of service with the company. Accumulated vacation days are almost certain to be used by an employee at some time if they are in danger of losing them.

Assume that a company pays its employees an average of \$100 per day, and that there are 50 unused vacation days at 12/31/X1 which accumulate but do not vest. Also assume that the company is giving a 10% raise to all employees, effective 1/1/X2. The company must accrue the vacation pay:

12/31/X1		
Vacation pay expense	5,500	
Liability for unused vacation days		5,500

Refundable Deposits

Finally, a client may receive **refundable deposits** on containers for products sold by the company. The deposit must be reported as a liability when collected but may later become revenue if there is an expiration date on the right of the customer to claim the refund.

Assume the company collects deposits of \$1 on containers used to transport the company's product to customers, and that customers must return the containers by the end of the calendar year following the year of the sale to receive a refund on the deposit. The following information applies to the first two years in which this policy applies:

Number of sales in 20X1	50
20X1 containers returned in 20X1	30
20X1 containers returned in 20X2	15
Number of sales in 20X2	60
20X2 containers returned in 20X2	40

In 20X1, entries are made for containers delivered and returned:

Cash	50	
Liability for refundable deposits		50
Liability for refundable deposits	30	
Cash		30

In 20X2, similar entries are made:

Cash	60	
Liability for refundable deposits		60
Liability for refundable deposits	55	
Cash		55

Additionally, an entry is made at 12/31/X2 for the expiration of the time allotted for the return of the remaining 20X1 containers ($50 - 30 - 15 = 5$):

Liability for refundable deposits	5	
Container revenue		5

Accrued & Deferred Amounts

Some companies pay **bonuses** to top-level executives based on the overall results of the organization. The calculation of these bonuses can get complicated, because they often are based on income in excess of certain amounts, and sometimes the bonus percentage is based on what income will be after the bonus is paid rather than before.

A company may pay the president a bonus equal to 10% of income in excess of \$400 after the bonus is deducted. Expressed using basic algebra, the bonus (B) on income (I) before deducting the bonus is:

- $B = 10\% (I - B - 400)$

If income before deduction of the bonus is \$510, the bonus formula will be solved as follows (10% will be expressed as .1):

- $B = .1 (510 - B - 400)$

The dollar amounts inside the parentheses can be combined:

- $B = .1 (110 - B)$

The items inside the parentheses can be individually multiplied by .1:

- $B = 11 - .1B$

Then .1B is added to both sides:

- $1.1B = 11$

Then both sides are divided by 1.1:

- $B = 10$

Some companies collect **subscriptions on publications** to be delivered in the future. On the exam, these commonly involve directories or other annual or semi-annual publications. As deferred revenues, these must be reported as earned only when the publications are delivered to customers.

Let's say the client publishes a directory twice a year, sending the May 15 edition to subscribers that have paid by April 30, and the November 15 edition to those who have paid by October 31. At 12/31/X1, unearned revenue of \$190 exists. During 20X2, the client collects \$1,200 evenly through the year, and publishes as promised.

To determine the subscription revenue in 20X2, consider that the 5/15/X2 publication earns the money collected up to 4/30/X2. Based on the information, cash collections in 20X2 are at the rate of $\$1,200 / 12 = \100 per month. Thus, \$400 came in during the first 4 months, and this was earned along with the \$190 from the start of the year (which presumably represented collections in 20X1 after 10/31/X1), for a total of \$590 revenue recognized on 5/15/X2.

The 11/15/X2 publication earns money collected between 5/1/X2 and 10/31/X2, which at the rate of \$100 per month comes to \$600 for those six months. The total revenue in 20X2 is $\$590 + \$600 = \$1,190$. A single entry reflecting all of the year's activity in 20X2 is:

Cash	1,200	
Unearned subscription revenue (balance)		10
Subscription revenue		1,190

Payroll taxes need to be accrued at the time related payroll expenses are recognized. It is important, however, to distinguish employer taxes from the employee taxes on payroll. The latter are not costs of the company, but instead represent withholdings from the gross pay of the employees. As a result, only employer taxes meet the definition of accrued expenses (costs recognized on the income statement before payment).

Let's assume social security taxes under FICA are assessed at an 8% rate for employers with an equal amount withheld from the paycheck of employees, that the employer pays unemployment taxes under FUTA at a 3% rate, and that federal income taxes are withheld from employee paychecks.

If an employee earns \$100 gross pay for a period, and is required to have \$15 withheld for federal income taxes, the entry to account for the paycheck and related taxes is as follows:

Payroll expense	100	
Payroll tax expense	11	
Cash		77
Accrued payroll taxes liability		11
Withholdings due to IRS		23

Dividends Payable

Dividends are considered a **current liability** when they are **declared** whether related to common stock or preferred stock. Dividends in arrears on cumulative preferred stock are not a liability but must be disclosed in the notes to the financial statements.